87-1589

No.

IN THE

Supreme Court of the United States

October Term, 1987

VERMONT DEPARTMENT OF TAXES,
Petitioner,

v.

LOREN D. KEYS and RENETTA J. KEYS,
Respondents

PETITION FOR WRIT OF CERTIORARI to the VERMONT SUPREME COURT

STATE OF VERMONT
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QUESTIONS PRESENTED

Do the Borrowing and Supremacy Clauses of the United States Constitution or 31 U.S.C. §3124(a) prohibit states from imposing an income tax on pensions that are derived from the pension fund's investment in federal obligations, when the tax is computed without reference to the income or assets of the payor?

LIST OF PARTIES

The parties to *Vermont Department of Taxes v. Keys* are the Vermont Department of Taxes, Petitioner, and Loren D. Keys and Renetta J. Keys, Respondents.

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The opinion of the Vermont Supreme Court in *Keys v. Vermont Department of Taxes*, No. 85-531 (Vt. Dec. 24, 1987) will not be reported. The Entry Order, which includes the entire opinion of the court, is printed at App. 1. Because the Entry Order makes reference to a companion case, *In Re Sawyer Estate*, No 86-177 (Vt. Dec. 11, 1987) (motion for rehearing pending), the opinion of the Vermont Supreme Court in that case is appended at App. 2. Also included in the appendix are the unpublished opinion of the Superior Court of Windsor County, Vermont (App. 9) and the unpublished determination of the Commissioner of Taxes (App. 22) in *Keys v. Vermont Department of Taxes*.

JURISDICTION

The opinion of the Vermont Supreme Court in *Keys v. Vermont Department of Taxes* was rendered on December 24, 1987. No motion for rehearing was filed. Jurisdiction in this court is vested by 28 U.S.C. §1257(3).

CONSTITUTIONAL PROVISIONS AND STATUTES

U.S. Const. Art. I, §8 cl. 2:

The Congress shall have Power . . . To Borrow Money on the credit of the United States;

U.S. Const. Art. VI, cl. 2:

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

31 U.S.C. §3124(a) (1982 ed.):

(a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except —

(1) a nondiscriminatory franchise tax or other nonproperty tax instead of a franchise tax, imposed on a corporation; and

(2) an estate or inheritance tax.

Vt. Stat. Ann. tit. 32 §5823(a)(1) (1981):

(a) For any taxable year, the Vermont income of a resident individual, estate or trust is the adjusted gross income of the taxpayers for that taxable year less:

(1) Income exempted from state taxation under the laws of the United States.

STATEMENT OF THE CASE

In 1981, Loren D. Keys received a lump sum distribution of $141,000 from the Savings Incentive Plan of Bankers Trust New York Corporation (the "Plan").

At issue is the taxation of $35,000, which the Plan received as interest from federal obligations and distributed to Mr. Keys as a pension.

The Plan is a qualified savings plan described in §401 of the Internal Revenue Code. Fund (A) created under the Plan, from which the distribution of $35,000 was made, invested in obligations of the United States, obligations guaranteed by the United States, and deposits in fully insured savings accounts, in the discretion of the trustees. The parties stipulated that the $35,000 in dispute was received by the Plan as interest from federal obligations.

On December 20, 1982, the Vermont Department of Taxes made an assessment against Mr. and Mrs. Keys, a husband and wife filing a joint Vermont income tax return, for tax owed on amounts distributed to Mr. Keys from the Plan. Mr. and Mrs. Keys appealed the assessment to the Commissioner of Taxes.

Mr. Keys first raised a federal question in the administrative proceedings before the Commissioner of Taxes. In his letter of appeal, Mr. Keys stated the issue as follows:

> The argument supporting my appeal is simple: "Interest from U.S. obligations is exempt from state taxation under the laws of the United States." Interest from U.S. obligations is included in the distribution from Bankers Trust Co., my employer. Therefore, that interest is exempt from State (Vermont) taxation.

Letter of Appeal to Commissioner dated January 6, 1983.

The Commissioner understood Mr. Keys' argument to be that Vermont could not *constitutionally* tax his receipt of money from the Plan. Determination

of Vermont Commissioner of Taxes (App. 24). The Commissioner concluded that the United States Constitution only exempts interest from federal obligations in the hands of the original recipient (App. 25). Although the Commissioner did not address 31 U.S.C. §3124(a) directly, he found that a specific federal statute would be required to pass the exempt character of the income to a taxpayer other than the original recipient and that no federal statute carries the exempt character of federal interest to distributions from an employee trust (App. 25).

Mr. Keys appealed the commissioner's determination to the Windsor Superior Court. The first specific mention of Rev. Stat. §3701, now codified at 31 U.S.C. §3124(a), appears in Mr. Keys' memorandum of law in that Court.

> Appellant herein argues that the Determination of the Commissioner of Taxes of the State of Vermont . . . is contrary to . . . the applicable United States Code Title 31, §742, Rev. Stat. §3701.

Appellant's Memorandum in the Windsor Superior Court, at p. 1.

The superior court stated the issue as follows:

> Taxpayers claim that because $35,000 received from the Plan represented interest on U.S. Government obligations, the United States Constitution and federal law [31 U.S.C. §742, now codified at 31 U.S.C. §3124] prohibits Vermont taxation of this income.

Notice of Decision of Windsor Superior Court (App. 10). The superior court concluded that 31 U.S.C. §742(a) codifies the constitutional immunity of federal

obligations and that Vermont's tax on Mr. Keys' pension is unconstitutional.

> A construction of the constitutional principle underlying the state tax immunity codified in 31 U.S.C. §742(a) does not depend on the weight of the burden or degree of interference with the constitutional power to borrow money on the credit of the United States . . . The state tax in issue could interfere with this constitutional power, if only slightly. It was, therefore, unconstitutional.

Notice of Decision of Windsor Superior Court (App. 21). The superior court reversed the determination of the Commissioner of Taxes and ordered the Department to issue a refund of $203 plus interest.

The Vermont Department of Taxes appealed the decision of the superior court to the Vermont Supreme Court. In a one paragraph ruling, the Vermont Supreme Court affirmed the decision of the superior court.

> The State stipulates that the lump sum payment received by the taxpayer represents income derived from his investment in a retirement fund which invests solely in federal obligations . . . Interest earned by the taxpayer on that investment must be characterized as income derived from federal obligations and as exempt from state taxation by 32 [sic] U.S.C. §3124(a). See *American Bank and Trust Co. v. Dallas County*, 463 U.S. 855, 862-63 (1983). The State's attempts to characterize the income otherwise are unavailing. See *In Re Sawyer Estate*, No. 86-177, slip op. at 3-4 (Vt. Dec. 11, 1987.)

Keys v. Department of Taxes, No. 85-531 (Vt. Dec. 24, 1987) (App. 1).

A complete understanding of the Vermont Supreme Court's decision in *Keys* requires consideration of a companion case, *In Re Sawyer Estate*, No. 86-177 (Vt. Dec. 11, 1987) (motion for rehearing pending). The Vermont Supreme Court in *In Re Sawyer Estate* concluded that Vermont may not impose a personal income tax on dividends paid by the Trust for Short-Term U.S. Government Securities (the "Trust") out of funds it received as interest from federal obligations. The court's explanation for striking down Vermont's tax on dividends is as follows:

> In *American Bank & Trust Company v. Dallas County*, 463 U.S. 855, 862 (1983) the Court emphasized the "sweeping" scope of the exemption from state taxation provided for by §3124(a). The Court then stated the statutory rule in plain language: "[Rev. Stat. §] 3701 prohibits any form of tax that would require consideration of federal obligations in computing the tax; . . ." *Id.* at 865.
>
> The State has stipulated, and the Trust's prospectus bears out the fact, that 71.62 per cent of the Trust's income was derived from investments in federal obligations. Because the Trust distributed the net income from these investments directly to the shareholders, the State's taxation of that income was unquestionably a tax on the interest income from federal obligations and therefore unlawful.

In Re Sawyer Estate, No. 86-177, slip op. at 3 (Vt. Dec. 11, 1987) (App. 5-6).

The court rejected the Department's argument that money received as federal interest loses its character as exempt federal interest when the recipient pays it over to a third party as a dividend or pension.

> The Department . . . [claims] that the Trust should not be treated as a "conduit" of the interest income in this manner. It asserts that the Trust is the recipient of the income rather than the shareholders and that the character of the income as interest from federal obligations is thereby lost. In view of the fact that the Trust distributed all of its net income directly to its shareholders instead of retaining it and reinvesting it in nonfederal obligations, the Department's distinction is unpersuasive.

In Re Sawyer Estate, slip op. at 3-4 (App. 6).

REASONS FOR GRANTING THE WRIT

SUMMARY OF ARGUMENT

The Petitioner urges this Court to grant its petition for writ of certiorari to determine important federal questions that have not been, but should be, decided by this Court. At issue is the breadth of the immunity granted to federal obligations by the Borrowing and Supremacy Clauses of the United States Constitution and 31 U.S.C. §3124(a).

Citing this Court's decision in *American Bank & Trust Company v. Dallas County*, 463 U.S. 855, 862 (1983), the Vermont Supreme Court has concluded that 31 U.S.C. §3124(a) prohibits the states from taxing pensions and mutual fund dividends that are paid with money that the payor received as federal interest. *Keys v. Department of Taxes*, No. 85-531 (Vt. Dec. 24, 1987); *In Re Sawyer Estate*, No. 86-177 (Vt. Dec. 11, 1987) (motion for rehearing pending). The decisions of the Vermont Supreme Court have serious financial and administrative consequences for the

State; if 31 U.S.C. §3124(a) is construed in this fashion, Vermont will be required to examine the source of all income payments and eliminate from its tax base any income that may be *traced to* the payor's investment in federal obligations. The protection granted to federal obligations by the Vermont Supreme Court far surpasses the immunity granted to federal obligations under the Borrowing and Supremacy Clauses of the United States Constitution. Although Congress has the authority to enact legislation that would prohibit the states from taxing income that is paid with money that was received by the payor as federal interest, neither the plain language nor legislative history of 31 U.S.C. §3124(a) suggests that Congress intended to constrict the states' taxing power to this extent.

Vermont's reliance on *American Bank* as authority for its expansive construction of section 3124 is misplaced. The Court in *American Bank* did not address the breadth of the immunity granted to federal obligations by the federal statute; when it stated that the immunity is "sweeping," it referred to the fact that it extends to every *form* of tax that includes federal obligations or federal interest, as such, in the computation of the tax. Nothing in this Court's decisions suggests that 31 U.S.C. §3124(a) prohibits a state income tax on dividends or pensions that is computed without consideration of the income or assets of the payor.

Vermont does not stand alone in reading 31 U.S.C. §3124(a) broadly. At least six other courts have concluded, on the authority of *American Bank*, that the 1959 amendment to Rev. Stat. §3701 prohibits the states from taxing dividends derived from a mutual

fund's investment in federal obligations. The courts reached this conclusion even though the tax at issue was computed without reference to the income or assets of the mutual fund. *Andras v. Illinois Department of Revenue*, 154 Ill. App. 3d 37, 506 N.E. 2d 439 (App. Ct. 1987), *petition for cert. filed*, ____ U.S.L.W. _____ (Jan. 5, 1988) (No. 87-1142); *Brown v Franchise Tax Board*, No. A035598 (Calif. Ct. App., Dec. 29, 1987); *Comptroller v. First United Bank & Trust* (Md. T.C., July 8, 1987), *appeal filed*, No. 87218095/CL69604 (Cir. Ct. Baltimore City); *Capital Preservation Fund, Inc. v. Department of Revenue*, No. 86-CV-1385 (Cir. Ct. Dane County, June 1, 1987), *appeal filed*, No. 87-1303 (Wis. Ct. App.); *Estate of Kraft v. Department of Revenue*, No. C85-789 (Cir. Ct., Hamilton County, Ind., Dec. 2, 1986); *Matz v. Department of Treasury*, 155 Mich. App. 778, 401 N.W. 2d 62 (1986). The states need guidance from this Court.

ARGUMENT

A. The Decision of the Vermont Supreme Court Has Serious Financial and Administrative Consequences for the State.

Although the opinions of the Vermont Supreme Court in *Keys* and *Sawyer* are terse, their ramifications are broad. The Vermont Supreme Court has apparently concluded that a state may not tax income that is paid with money that the payor received as interest from federal obligations.

The reasoning of the Vermont Supreme Court in *Keys* and *Sawyer* suggests that substantial revenues are at stake for the State. If 31 U.S.C. §3124(a) is construed to prohibit the states from taxing income that is derived from federal obligations, Vermont could be

prohibited from taxing not only pensions and mutual fund dividends, but also dividends paid by an ordinary business corporation or interest paid on bank deposits, so long as the payee could satisfy its burden of tracing the payment to the payor's investment in federal obligations. It logically follows that Vermont could also be prohibited from taxing wages paid to employees, rent paid to a landlord, or other income that is normally subject to state taxation, if it could be shown that this income was paid with money that the payor received as interest from federal obligations.

The decisions of the Vermont Supreme Court also impose a substantial administrative burden on Vermont. The State will be required to scrutinize the portfolio of every pension fund, mutual fund and potentially any other legal entity, to determine the extent to which the entity invests in federal obligations and to exclude from its tax base a proportionate share of any payments by the entity that may be traced to its investment in federal obligations. If an entity invests in part in tax exempt federal obligations and in part in taxable assets, the State will be required to make difficult decisions concerning the allocation of expenses between exempt and taxable income in order to determine what portion of a payment may be taxed by the State.

B. The Plain Language of 31 U.S.C. §3124(a) Does Not Support Vermont's Expansive Construction of the Statute.

Prior to 1959, Rev. Stat. §3701 prohibited only a direct tax on the stocks and obligations of the United States. Act of Feb. 25, 1862, ch. 33, §2, 12 Stat. 346. In 1959, Congress amended Rev. Stat. §3701 by adding a second sentence.

> This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

Act of Sept. 22, 1959, Pub. L. 86-346, §105(a), 73 Stat. 622. The statute, previously codified at 31 U.S.C. §742, was reformulated without substantive change and enacted into positive law in 1982. The statute now reads:

> Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligations, the interest on the obligation, or both, to be considered in computing a tax, except —
>
> (1) a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and
>
> (2) an estate or inheritance tax.

31 U.S.C. §3124(a) (192 ed.). Although the codification at 31 U.S.C. §742 technically controls this case, the Vermont Supreme Court based its decision in *Keys* on 31 U.S.C. §3124(a). In *Sawyer*, the court concluded that the two codifications are identical in meaning. *In Re Sawyer Estate*, slip op. at 2 (App. 5).

The Vermont Supreme Court has construed 31 U.S.C. §3124(a) broadly. The court has apparently concluded that a state income tax on pensions unlawfully requires interest from federal obligations "to be considered in computing a tax" if it can be established

that the pension was paid with money that was received by the pension fund as federal interest.

The Vermont Supreme Court has expanded 31 U.S.C. §3124(a) beyond its plain meaning. On its face, 31 U.S.C. §3124(a) prohibits only those state taxes that require federal obligations or federal interest, *as such*, to be considered in computing a tax; it does not extend to taxes on pensions, dividends or other income that may be *traced to* the payor's investment in federal obligations. The statute would prohibit, by way of example, a tax on pension income that was computed by determining the income received by the pension fund, including its income from federal obligations, and taxing each pensioner on a proportionate share of the mutual fund's income. *See American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983). It does not prohibit a tax on pensions that is computed without consideration of the income or assets of the payor.

Vermont's personal income tax does not violate 31 U.S.C. §3124(a). Vermont imposes a broad based tax on income earned or received by a corporation, individual, estate or trust. This income includes pensions. The tax is measured solely by the amount of income received by the taxpayer. The tax in no way considers the assets of the payor or the source of any income earned by the payor.

C. The Legislative History of 31 U.S.C. §3124(a) Does Not Support the Vermont Supreme Court's Expansive Construction.

The legislative history of 31 U.S.C. §3124(a) does not support the expansive construction given to the statute by the Vermont Supreme Court. The legislative history only indicates that Congress intended to

prohibit taxes that are calculated with reference to the value of federal securities or the income produced by those securities.

The catalyst for the 1959 amendment to Rev. Stat. §3701 was an Idaho tax "upon every individual . . . measured by his net income," including income from federal obligations. *American Bank*, 463 U.S. at 865-66. The Court had previously determined that interest from federal obligations is exempt from state taxation. *New Jersey Realty Title Insurance Co. v. Division of Tax Appeals*, 338 U.S. 665, 675-76 (1950). Idaho's justification for the tax was that it was not a prohibited tax on exempt federal interest, but a tax on the individual, and was merely measured by his net income, including his income from federal obligations. Such a distinction was appropriately criticized as "rest[ing] upon a distinction of words which is without substance." *American Bank*, 463 U.S. at 866 (quoting *Hearings on Public Debt Ceiling and Interest Rate Ceiling on Bonds Before the House Committee on Ways and Means*, 86th Cong. 1st Sess., 71 (1959) (statement of Secretary of Treasury Anderson)).

Prior to the amendment of Rev. Stat. §3701 in 1959, this Court concluded that the states could lawfully impose a tax that was measured by the value of federal obligations or the interest from federal obligations, so long as the tax was nominally imposed on a property interest or transaction separate from the ownership of the federal obligations. *American Bank*, 463 U.S. at 862 (citing *Plummer v. Coler*, 178 U.S. at 129; *Home Insurance Company v. New York*, 134 U.S. 594, 600, 602, 606 (1890)). The Court persisted in formalistic distinctions of this sort even when it recognized that there is no practical distinction between a

tax imposed on federal obligations and a tax imposed on a separate property interest that is computed in the same manner as a tax on federal obligations. *American Bank*, 463 U.S. at 862 (citing *Society Savings v. Bowers*, 349 U.S. 143, 148 (1955)).

The 1959 amendment to section 3701 did away with the formalistic distinction between a tax on federal obligations and a tax on a separate property interest that is measured by federal obligations. *American Bank*, 463 U.S. at 867. The amendment prohibits any tax that includes federal obligations or the interest thereon in the tax base.

Vermont's income tax on pensions does not make the type of "formalistic distinction" with which the 1959 amendment to section 3701 was concerned. A tax on pension income is not equivalent to a tax on federal obligations held by the payor. A taxpayer is not taxed on a proportionate share of the payor's income or assets, but on the amount of income received. The individual's tax liability depends on the individual's income and deductions as opposed to the income or deductions of the payor.

D. The Decisions Of This Court Do Not Support the Vermont Supreme Court's Construction Of 31 U.S.C. §3124(a).

As authority for its broad construction of 31 U.S.C. §3124(a), the Vermont Supreme Court cited this Court's decision in *American Bank & Trust Company v. Dallas County*, 463 U.S. 855 (1983). The Vermont Court focused on language in this Court's opinion that says that the exemption provided by Rev. Stat. §3701 is "sweeping." *In Re Sawyer Estate*, No. 86-177, slip. op. at 3 (Vt. December 11, 1987) (quoting *American Bank*, 463 U.S. at 862).

This Court's opinion in *American Bank* does not support Vermont's construction of the statute. When this court said the exemption provided by Rev. Stat. §3701 was "sweeping," it referred to the fact that the 1959 amendment significantly broadened the *forms* of taxes which were prohibited under prior decisions of the Court. The amendment prohibits a tax that is nominally imposed on a property interest or transaction separate from the ownership of federal obligations if the tax is computed with reference to federal obligations or federal interest. *American Bank*, 463 U.S. at 862-65. The amendment encompasses "*every form* of taxation" that is not specifically excepted in the statute, including taxes on bank shares. *American Bank*, 463 U.S. at 864. The Court rejected arguments that the statute applied only to certain forms of taxes, such as income taxes. 463 U.S. at 866-67.

In one sense, *American Bank* was a simple case. There was little question that Texas' tax on bank shares considered federal obligations in the computation of the tax. The tax required bank shareholders to determine the value of the bank's capital assets, including federal obligations, subtract the bank's liabilities and the value of its real estate, and divide the result by the number of shares. *American Bank*, 463 U.S. at 860.

The difficult issue presented by *American Bank* was whether 31 U.S.C. §3124(a) extended to bank share taxes. The taxing authority argued that a separate statute, Rev. Stat. §5219, should be read to create an implied exception for bank share taxes because this Court's decisions in *Van Allen v. Assessors*, 70 U.S. (3 Wall.) 573 (1865), *Cleveland Trust Co. v. Lander*, 184 U.S. 111 (1902), and *Society For Savings v. Bowers*, 349 U.S. 143 (1955), were based on a predecessor of

Rev. Stat. §5219 and held that states could lawfully impose bank share taxes that included federal obligations in the computation of the tax. The majority in *American Bank* concluded that the predecessor to section 5219 only addressed the states' *authority* to impose a tax on bank shares and that the *form* of bank share taxes was prescribed by Rev. Stat. §3701. The Court concluded that the 1959 amendment to Rev. Stat. §3701 precluded a bank shares tax that was computed with reference to the bank's federal obligations. *American Bank*, 463 U.S. at 871-73.

American Bank only addressed the *forms* of taxation that must allow an exemption for federal obligations; it did not examine the *scope* of the exemption provided by 31 U.S.C. §3124(a). *First National Bank of Atlanta v. Bartow County Board of Tax Assessors*, 470 U.S. 583, 589 (1985). In *Bartow*, the Court addressed the scope of the 1959 amendment to Rev. Stat. §3701 and found that the amendment did not broaden the exemption for federal obligations beyond that mandated by the Constitution. *Bartow*, 470 U.S. at 593-94.

E. The Immunity Granted to Federal Obligations by the Vermont Supreme Court Far Surpasses the Immunity Granted by the Borrowing and Supremacy Clauses of the United States Constitution.

Because Congress has comprehensively legislated the immunity for federal obligations since 1959, there is little recent authority describing the contours of the *constitutional*, as opposed to *statutory*, immunity for federal obligations. The immunity granted to federal obligations by the Vermont Supreme Court far exceeds the immunity granted to federal obligations under pre-1959 decisions of this Court and the tax im-

munity generally granted to the Federal Government in more recent decisions of the Court.

Prior to the amendment of Rev. Stat. §3701 in 1959, this Court concluded that the Borrowing and Supremacy Clauses of the United States shield federal obligations from direct state and local taxation and from indirect taxation through their inclusion in a tax imposed on all of the property of a taxpayer. *Society for Savings v. Bowers*, 349 U.S. 143, 144 (1955); *Weston v. Charlestown*, 27 U.S. 449 (1829). The Court also concluded that the Constitution precludes taxation of the interest generated by federal obligations. *New Jersey Realty Title Insurance Co. v. Division of Tax Appeals*, 338 U.S. 665, 675-76 (1950).

The Court struck down state taxes on the corporate property or capital of a corporation owning exempt obligations, *Bank Tax Case*, 69 U.S. 200 (1865), but sustained taxes on their franchise or privileges, even if federal obligations were included in the measure of the tax. *Werner Machine Co. v. Director of Division of Taxation*, 350 U.S. 492 (1956); *Home Insurance Co. v. New York*, 134 U.S. 594 (1890). The Court noted that "[t]he taxability of the franchises of a corporation without reference to the character of the property in which its capital stock or its deposits are invested" had been sustained in previous cases. *Home Insurance Co. v. New York*, 134 U.S. at 602.

The Court also upheld other taxes on property interests or transactions separate from the ownership of federal obligations. *Society for Savings v. Bowers*, 349 U.S. 143, 148 (1955). The Court permitted, for example, a tax on a shareholder's interest in a national or state bank that held federal obligations because a tax on the shareholder's interest is distinct from a tax on

the capital of the bank. *Van Allen v. Assessors*, 70 U.S. (3 Wall.) 573, 584 (1865); *Home Savings Bank v. Des Moines*, 205 U.S. 503 (1907).

This Court suggested in *Miller v. Milwaukee*, 272 U.S. 713 (1927), that it would uphold a tax on dividends paid to shareholders of a corporation that invested all of its property in United States bonds, so long as the tax was not aimed at reaching exempt federal bonds.

> There is no doubt that in general a corporation is a nonconductor that cuts off connection between dividends to its shareholders and the corporate funds with which the dividends are paid. *Des Moines National Bank v. Fairweather*, 263 U.S. 103. A system of taxation that applied to shareholders of all corporations equally might tax, we assume for purposes of argument, the stockholders of a corporation that had invested all its property in United States bonds.

The Court invalidated Wisconsin's tax on corporate dividends only because it found that the tax discriminated against federal bonds. 272 U.S. at 715.

Although recent decisions addressing the constitutional immunity of federal obligations are lacking, decisions relating to the general immunity of the Federal Government from state taxation support the Petitioner's contention that the immunity is narrow. Recent decisions limit the implied immunity to a protection against direct or discriminatory taxes. *Washington v. United States*, 460 U.S. 536, 540 (1983); *United States v. New Mexico*, 455 U.S. 728, 732 (1982). In the face of these decisions, it is incongruous that Vermont has concluded that the Constitution prohibits a tax on pensions that may be traced to the payor's investment in federal obligations.

The decision in *Keys v. Department of Taxes* is reminiscent of *New York ex rel. Rogers v. Graves*, 299 U.S. 401 408-09 (1937), which held that the salary paid to a federal employee is immune from state taxation. *New York ex rel. Rogers v. Graves* was decided when federal tax immunity reached its zenith; two years later, the court specifically overruled the decision in *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466 (1939). In holding that a state may constitutionally impose a tax on the income paid to an employee of the Federal Home Owners' Loan Corporation, the Court stated:

> The theory, which once won a qualified approval, that a tax on income is legally or economically a tax on its source, is no longer tenable, *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 313, 314; *Hale v. State Board*, 302 U.S. 95, 108; *Helvering v. Gerhardt*, *supra*; cf. *Metcalf & Eddy v. Mitchell*, 269 U.S. 514; *Fox Film Corp. v. Doyal*, 286 U.S. 123; *James v. Dravo Contracting Co., supra*, 149; *Helvering v. Mountain Producers Corp.*, 303 U.S. 376 . . .

Graves v. New York ex rel. O'Keefe, 306 U.S. at 480-81.

The 1959 amendment to Rev. Stat. §3701 did not abolish the historic distinction between a tax on income and a tax on its source. The statute now prohibits a tax on pensioners that is computed with reference to the federal obligations held by the pension fund, or the interest thereon, but it does not prohibit any other form of tax. Neither the Constitution nor 31 U.S.C. §3124(c) prohibits a nondiscriminatory income tax that is based on the amount of income received and not on the income or assets of the payor.

CONCLUSION

A review of the decision in *Vermont Department of Taxes v. Keys* is necessary to clarify the scope of the statutory and constitutional immunity granted to federal obligations. The Vermont Supreme Court and six other state courts have concluded that this Court's decision in *American Bank* bars the states from imposing nondiscriminatory taxes on income that is derived from the payor's investment in federal obligations, even if the tax is computed without reference to the income or assets of the payor.

The decisions in Vermont and the other state courts hark back to an earlier era when federal tax immunity was freely extended to private parties who established a relationship with the Federal Government. This Court, recognizing that such decisions unduly erode the states' taxing authority, has retreated from an expansive construction of the constitutional tax immunity granted to federal obligations since its decision in *James v. Dravo Contracting Co.*, 302 U.S. 134 (1937).

Although Congress has authority to expand the narrow immunity granted to federal obligations under the Borrowing and Supremacy Clauses of the Constitution, clear language is required. *Rockford Life Insurance Co. v. Illinois Department of Revenue*, 482 U.S. ___ 107 S. Ct. 2312, 2317-18 (1987). The plain language and legislative history of 31 U.S.C. §3124(a) indicate that the statute only prohibits taxes on federal obligations or federal interest and taxes that are nominally imposed on a separate property interest, but include federal obligations or federal interest, as such, in the measurement of the tax. Neither the Constitution nor 31 U.S.C. §3124(a) prohibits an income tax

simply because the income was paid with money that was received by the payor as interest from federal obligations.

Respectfully submitted,

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APPENDIX

ENTRY ORDER

SUPREME COURT DOCKET No. 85-531

February Term, 1987

Entered: December 24, 1987

Loren D. and Renetta J. Keys	)	APPEALED FROM:
	)	Windsor Superior Court
v.	)	
	)	
Vermont Department of Taxes	)	DOCKET NO. S11-83-WrM

In the above entitled cause the Clerk will enter:

The State stipulates that the lump sum payment received by the taxpayer represents income derived from his investment in a retirement fund which invests solely in federal obligations. The prospectus for the retirement plan containing the fund shows that the taxpayer elected to invest in that fund as one of five options and that his selection was made to ensure that, once placed in the fund, the money he invested could only be invested in federal obligations. Interest earned by the taxpayer on that investment must be characterized as income derived from federal obligations and as exempt from state taxation by 31 U.S.C. §3124(a). See *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 862-63 (1983). The State's attempts to characterize the income otherwise are una-

vailing. See *In re Sawyer's Estate*, No. 86-177, slip. op. at 3-4 (Vt. Dec. 11, 1987).

Affirmed.

BY THE COURT:

Frederic W. Allen,
Chief Justice

Albert W. Barney,
Chief Justice (Ret.),
Specially Assigned

F. Ray Keyser,
Associate Justice (Ret.)
Specially Assigned

Stephen B. Martin,
Superior Judge
Specially Assigned

Edward J. Costello,
District Judge (Ret.),
Specially Assigned

No. 86-177

In re Thomas C. Sawyer Estate

Supreme Court

On Appeal from Chittenden Superior Court

February Term, 1987
Entered: December 11, 1987

Matthew I. Katz, Jr.

B. Michael Frye and Charles F. Storrow of Paul, Frank & Collins, Inc., Burlington for plaintiff-appellee

Jeffrey L. Amestoy, Attorney General, and Elizabeth Dennis Anderson, Assistant Attorney General, Montpelier, for defendant-appellant

PRESENT: Allen, C. J., and Barney C. J. (Ret.), Keyser, J. (Ret.), Costello, D. J. (Ret.), and Martin, Supr. J., Specially Assigned

COSTELLO, D. J., Specially Assigned. The Department of Taxes (Department) appeals from the trial court's holding that certain income received by the appellee Estate (Estate) is not taxable. We affirm in part and reverse in part.

Part of the Estate's income is dividend income received from the Trust for Short Term United States Government Securities (Trust). For the fiscal year

ending November 30, 1983, the Estate received a distribution of $4,039.38 from the Trust. The administrator filed a Vermont fiduciary income tax return for this distribution and paid a tax on the full amount.

On May 7, 1984, the administrator filed an amended return for fiscal year 1983, seeking a refund of the tax it had paid on the distribution from the Trust. The Department refunded the amount of tax paid on distributions received on or before May 31, 1983, but refused to refund the amount paid on distributions received after that date. The proration of the refund stemmed from a change in the Department's policy for treating income from the Trust. On May 31, 1983, the Department notified the Trust that it had reversed its earlier policy and would treat distributions received from the Trust from that day forward as taxable income.

During the period May 31 through November 30, 1983, for which the Department refused to refund the challenged tax, the Trust derived 71.62 percent of its income from investments in securities issued by the United States government and the remaining 28.32 percent from investments in "repurchase agreements" for government securities. The Trustees distributed all of the net income from these investments to its shareholders. The Trust instrument provides for retention and reinvestment of net income and for trading in nongovernmental securities, but the Trustees did not exercise either of these options during the period in question.

The Estate appealed the Department's ruling to the Commissioner of Taxes, claiming that the income was exempt from state taxation under 31 U.S.C.

§3124(a), which precludes state taxation of federal obligations or "the interest thereon."* The Commissioner disagreed and affirmed the Department's refusal to refund the tax. The Estate then appealed to the superior court, pursuant to 32 V.S.A. §5885(b) and V.R.C.P. 74(a). The court reversed the Commissioner's ruling, holding that all of the income received from the Trust was exempt from state taxation under 31 U.S.C. §3124(a). The Department appeals from the trial court's decision. The parties have stipulated to the facts as found by the Commissioner and dispute only the applicability of 31 U.S.C. §3124(a).

A.

In *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 862 (1983), the Court emphasized the "sweeping" scope of the exemption from state taxation provided for by §3124(a). The Court then stated the statutory rule in plain language: "[Rev. Stat. §] 3701 prohibits any form of tax that would require consider-

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* Section §3124(a) provides:

Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except —

(1) a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and

(2) an estate or inheritance tax.

When the claim was filed, §3124(a) was codified as 31 U.S.C. §742. Both are codifications of Rev. Stat. §3701. The parties agree that §742, though slightly different in form than §3124(a), is identical in meaning, and that §3124(a) should be viewed as the applicable statute.

ation of federal obligations in computing the tax; . . ." *Id.* at 865.

The State has stipulated, and the Trust's prospectus bears out the fact, that 71.62 per cent of the Trust's income was derived from investments in federal obligations. Because the Trust distributed the net income from these investments directly to the shareholders, the State's taxation of that income was unquestionably a tax on the interest income from federal obligations and therefore unlawful.

The Department attempts to elude this straightforward application of the plain meaning of the statute by claiming that the Trust should not be treated as a "conduit" of the interest income in this manner. It asserts that the Trust is the recipient of the income rather than the shareholders and that the character of the income as interest from federal obligations is thereby lost. In view of the fact that the Trust distributed all of its net income directly to its shareholders instead of retaining it and reinvesting it in nonfederal obligations, the Department's distinction is unpersuasive.

The State also contends that Vermont's taxation scheme of "piggybacking" its tax onto the federal procedure makes §3124(a) inapplicable. Under the state taxation scheme, the state tax is computed as a fixed percentage of the federal tax; that which is taxable as federal income is taxable as state income, and that which is exempt from federal taxation is exempt from state taxation. According to the State, the interest income at issue is subject to federal taxation under the federal revenue code and should therefore be subject to state taxation absent an express act by the state legislature to remove the applicable federal code pro-

visions from the state statutory scheme. As the trial court concluded, however, the federal revenue code only defines federal income tax law and has no bearing on the issue of state taxation. Moreover, federal law with respect to state taxation is set forth by §3124(a), and it is applicable by virtue of the Supremacy Clause, Article VI of the United States Constitution regardless of state action or inaction to the contrary.

B.

The trial court further concluded that no distinction could be drawn between Trust income derived directly from federal obligations and that obtained as profits from repurchase agreements. This conclusion was erroneous. While the repurchasing agreements nominally involve federal obligations, the profits derived therefrom are not interest income attributable to the federal obligations.

When holding federal obligations as part of a repurchase agreement, the Trust holds them, in essence, as security for a loan to the original purchaser of the federal obligations. When entering into a repurchase agreement, the original purchaser becomes a "seller" and conveys the federal obligation to the Trust. The parties agree to a reconveyance of the obligation at a future time for the sale price plus an agreed upon interest rate. As part of the agreement, the Trust pays the interest earned on the federal obligation directly to the seller or retains it and turns it over to the seller when the security is repurchased. It must keep the repurchase agreement securities separate from other trust securities and cannot convey them to anyone except the seller in accordance with the agreement. The seller thus benefits by gaining access to the capital in-

vested in the federal obligation, plus the interest thereon, while the trust benefits from the interest earned on the loan provided to the seller. The income gained by the Trust from these arrangements is therefore interest income on the loan the Trust provides the seller, rather than interest income derived from the federal obligation, and is not exempt from state taxation under §3124(a). See *American National Bank of Austin v. United States*, 421 F. 2d 442 (5th Cir. 1970).

The order is affirmed with respect to the 71.62 per cent of the interest income derived from investments in federal obligations; the order is reversed and remanded with respect to the remaining income derived from repurchase agreements.

FOR THE COURT:

Edward J. Costello,
District Judge (Ret.)
Specially Assigned

STATE OF VERMONT

WINDSOR COUNTY, SS.

Entered: November 21, 1985

LOREN D. KEYS AND RENETTA J. KEYS	* *	WINDSOR SUPERIOR COURT
	*	
v.	*	
	*	
VERMONT DEPARTMENT OF TAXES	* *	DOCKET NO. S11-83-WrM

NOTICE OF DECISION

This case came before the Court on appeal, pursuant to 32 V.S.A. §5885(b) and V.R.C.P. 74(a), from a decision of Vermont Commissioner of Taxes, after a formal hearing, upholding the Department of Taxes assessment of taxpayers' Vermont personal income tax for calendar year 1981. The issue presented on appeal is whether the Commissioner erred in her determination that a lump sum distribution received by taxpayers from the Savings Incentive Plan of Bankers Trust New York Corporation (the Plan) was subject to Vermont income tax, to the extent that the distribution constituted income received by the Plan from interest on United States Government obligations.

The Commissioner's Findings of Fact are not contested. In 1981, Mr. Keys, upon his retirement, received a lump sum distribution of $141,000 from the Savings Incentive Plan of Bankers Trust New York

Corporation (The Plan). Of that distribution, $35,000 represented income from interest on United States Government obligations received by the Plan from its investments. Following a hearing before this Court the parties stipulated as follows: 1) The prospectus for the Plan, admitted into evidence as Exhibit G in the hearing before the Commissioner of Taxes, accurately described the Plan; and 2) The Plan was a defined contribution savings plan, which, according to the prospectus, is qualified under Section 401 of the Internal Revenue Code of 1954, as amended by the Employment Retirement Income Security Act of 1974. Both parties agree, and the Commissioner found, that if the $35,000 distribution to taxpayers constituted non-taxable income, taxpayers are due a tax refund of $203.00, plus interest. If, however, the $35,000 distribution was taxable by the State, the taxpayers owed additional tax of $1,246.00, plus interest.

DISCUSSION

Review in Superior Court is an appellate review of the record made before the Commissioner of Taxes. *Vermont Department of Taxes v. Tri-State Industrial Laundries, Inc.*, 138 Vt. 292, 298 (1980). Findings of an agency in support of its action will not be set aside unless clearly erroneous. *In re Troyse*, 142 Vt. 612, 616 (1983). This Court, however, must assess independently the Commissioner's conclusions of law. *See American National Bank of Austin v. U.S.*, 421 F. 2d 442, 451, *cert. denied* 400 U.S. 819 (1970).

Taxpayers claim that because $35,000 received from the Plan represented interest on U.S. Government obligations, the United States Constitution and federal law prohibits Vermont taxation of this income.

Taxpayers rely on 31 U.S.C. §742* (now codified as 31 U.S.C §3124, effective 1982) which prohibits taxation by a state of U.S. Government obligations. The exemption applies broadly to:

> every form of taxation that would require that either the obligations, or interest thereon, or both, be considered, directly or indirectly, in computing a tax . . .

31 V.S.A. §724(a). The statute specifically excludes from exemption estate and inheritance taxes and nondiscriminatory franchise or other non-property taxes. 31 U.S.C. §742(a)(1) and (2).

The above limitation on a state's taxing power is not technically an "exemption," but rather an "immunity" from taxation, based on the constitutional power of the United States Government to borrow money on credit of the United States, and the Supremacy Clause. *See U.S. Constitution*, Article I, §8 and Article IV, Clause 2; *Weston v. City Council of Charleston*, 2 Pet. 449 (1829). As the U.S. Supreme Court has reasoned:

> A state tax, however small, upon such securities or interest derived therefrom, interferes or tends to interfere with the constitutional power to borrow money on the credit of the United States, and constitutes a burden upon the operations of government, and carried far enough would prove destructive. *Macallen Co. v. Commonwealth of Massachusetts*, 279 U.S. 620 (1929).

Accordingly, 31 U.S.C. §742(a) merely codified this constitutional immunity; Supreme Court deci-

* Because the State tax in issue here was levied in 1981, the former Rev. Stat. §3701, codified at 31 U.S.C. §742, rather than 31 U.S.C. §3124(a), technically controls this case.

sions have treated Section 742(a) as principally a restatement of the constitutional rule. *Memphis Bank & Trust Co. v. Garner*, 103 S. Ct. 692, 697 (1983), citing *New Jersey Realty Title Inc. Co. v. Division of Tax Appeals*, 338 U.S. 665, 672 (1950). Its purpose is "to prevent taxes which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit." *New Jersey Realty Title Insurance Co., supra*, at 675, citing *Smith v. Davis*, 324 U.S. 111, 117 (1944).

The State counters taxpayers' claim with the argument that immunity from state taxation of interest earned on federal obligations belonged to the Plan upon receipt of that interest, not to taxpayers upon distribution of same. The interest received by the Plan lost its character as federal interest when it left the hands of the recipient (the Plan) and was distributed to taxpayers.

The State analogizes taxpayers' claim to that of a business which pays salaries with money derived from investments in U.S. obligations. While the business was exempt from state taxation on this money, the employees' salaries are not exempt from state taxation. The Commissioner based her determination, in part, on this reasoning, concluding:

> There is no principle of constitutional law which says that income which originates as interest on U.S. Government obligations is exempt for so long as that specific money can be traced. The Department's example, cited above, of the employer who pays his employees' wages with such interest is a common-sense example of the fact that the taxpayer's argument in this regard is not correct.

In re Keys, Personal Income Tax, Appeal No. ATC-83-6 at 4-5 (June 20, 1985).

Such a specious analogy does not assist this Court's determination of whether the particular state tax assessed is constitutionally permissible. Taxpayers have not claimed that tax-exempt income is tax-free "so long as it can be traced." Moreover, the analogy is not factually similar to this case. The Plan is not a business entity subject to federal income taxation. In fact, income earned by the Plan with funds held in trust is subject to neither federal income taxation, *see* I.R.C. §401 and §501(a), nor state income taxation by New York, the situs of the Plan. *See* N.Y. Tax Law §601(d) (McKinney) (a trust exempt from federal income tax is also exempt from New York State income taxation).

The State further asserts that interest on U.S. Government obligations is exempt only in the hands of the original recipient, unless there is a specific federal statute to pass through the tax-exempt character of such income. The Commissioner embraced this assertion and concluded:

> Interest on U.S. Government obligations is exempt from state taxation only in the hands of the original recipient. It requires a specific federal statute to pass through the tax-exempt character of such income to a taxpayer other than the original recipient. See, as examples of such statutes, Sections 652(b), 661(b), and 852 of the Internal Revenue Code. No federal statute authorizes a pass-through of exempt-character on distributions of this kind from an employee trust.

ID. at 4.

This conclusion is fallacious. The only "specific federal statute" which controls the issue presented is 31 U.S.C. §742(a). The Internal Revenue Code, Sections 652(b), 661(b) and 852, regulate federal income taxation, not state income taxation. The Code is obviously silent on the issue of state taxation of federal obligations and interest derived thereon because such obligations and interest are 100% taxable by the federal government. The absence of an I.R.C. section specifying a pass through of the tax-exempt character of income distributed by a §401 employee trust for purposes of *state* taxation is, therefore, not dispositive.

The Code sections referred to in the Commissioner's conclusions, I.R.C. §§652(b), 661(b) and 852, determine the tax-exempt status of interest income earned on state and municipal obligations under I.R.C. §103(a)(1). This exemption is distinctly different from the constitutional and statutory immunity from state taxation of interest income earned on federal obligations. The statutory exemption from federal income taxation of interest on state or municipal obligations, I.R.C. §103(a)(1), is an act of grace, not of constitutional necessity. Therefore, Section 103(a)(1) exemptions must be narrowly construed. *American National Bank of Austin, supra*, at 451.

In contrast with the principle of tax immunity, where the power to tax is absent, relinquishment of the power to tax cannot be presumed; exemptions must be in clear and unmistakable terms. For this reason, specific sections of the Internal Revenue Code authorize a passthrough of the tax exempt character of Section 103(a)(1) income. Without such authorization, no exemption is granted. For example, distributions from exempt §401 employees' trusts cannot qualify as tax exempt interest under I.R.C. §103(a)(1). *See*

Rev. Rul. 55-61, 1 C.B. 40 (1955) (taxation of §401 trust distributions governed by the liberal provisions of §§402 and 403); *acord rev. Rul.* 72-99, 1 C.B. 115 (1972) (cash dividends distributed by §401 trust not exempt under the provisions of I.R.C. §116).

The State's reliance on *Woodroof v. Tax Commissioner,* 440 A.2d 854 (Ct. 1981), for the proposition that interest derived from U.S. Government obligations does not retain that character upon distribution from a §401 trust, is misplaced. *See* Vermont Department of Taxes, *Memorandum of Law*, Docket No. S11-83-WrM, at 6. The court in *Woodruff* considered a taxpayer's claim that a distribution from a regulated investment company (mutual fund) was tax-exempt interest for purposes of state taxation. Under federal law, a regulated investment company is qualified to pay exempt interest dividends only if at least fifty percent of the value of the total assets of the company consists of tax exempt obligations. *See* I.R.C. §852(b)(5). The taxpayer did not claim that the distribution they received qualified as tax-exempt interest dividends under I.R.C. §852(b)(5), and therefore, the interest income of the investment company did not flow through to the taxpayer for purposes of the federal tax exemption under I.R.C. §103(a)(1). *Woodruff, supra*, at 856-57. Because the scheme of state taxation incorporated the federal tax scheme for taxation of dividends, the court held that the distribution of tax-exempt interest received by the investment company was taxable by the state.

The court in *Woodruff* was considering state taxation of interest derived from state obligations, not from U.S. obligations. Such interest is fully taxable by both state and federal governments absent a specific statute exempting the income from taxation. There-

fore, the character of such interest received by the investment company did not flow through to the taxpayers; the specific statutory requirement for such exemption was not met.

In contrast with federal tax exemptions, where taxation is the rule and an exemption is the exception, the language of 31 U.S.C. §742 is "inconsistent with implied exceptions" to the statutory rule prohibiting state taxation. *American Bank and Trust Co. v. Dallas County*, 103 S. Ct. 3369, 3375 (1983). The principle of broad immunity from state taxation given federal obligations and interest thereon is clearly demonstrated in the recent Supreme Court decision cited above. The Court in *American Bank & Trust Co. v. Dallas County* disallowed a property tax imposed by Texas on bank shares. In computing the value of each share the state considered the value of U.S. obligations held by banks. The Court recognized that prior to a 1959 amendment to Rev. Stat. §3701, 31 U.S.C. §742, it had permitted states to impose taxes on corporate shares even when the value of that interest was measured by underlying United States obligations, a practice "firmly embedded in the law." *Id.* at 3372, citing *Society for Savings v. Bowers*, 349 U.S. 143, 148 (1955). This formalistic approach to 31 U.S.C. §742 was based on the theory that a tax on a stockholder's interest or transaction separate from the ownership of federal obligations is not a tax on the federal obligations which are included in the corporate property because it was assessed on a discreet interest separate from the federal obligations. *Id.* at 3379.

American Bank & Trust rejected this earlier approach, reasoning that Congress, by amending 31 U.S.C. §742, "intended to sweep away formal distinc-

tions and to invalidate all taxes measured directly or indirectly by the value of federal obligations, except those specified in the amendment. *Id.* at 3377. The Court, in light of the plain language of 31 U.S.C. §742, held that the tax on bank shares takes into account, at least indirectly, the federal obligations that constitute a part of the bank's assets and therefore violated the statute. *Id.* at 3374.

Although *American Bank & Trust Co. v. Dallas County* does not directly address the issue raised by this appeal, it is helpful. This case clarifies the necessary approach for purposes of deciding this appeal. *American Bank & Trust Co.* began its analysis of the issue with a consideration of the true nature of the state tax assessment in relation to the clear meaning of 31 U.S.C. §742, which controlled the discussion. Furthermore, formal distinctions were ignored; given the broad scope of 31 U.S.C. §742, which codified the constitutional immunity from state taxation, the presumption was against state taxation and no exceptions were implied. This Court's inquiry, therefore, is narrowed to whether, in practical operation and effect, Vermont's income tax assessment is, in part, a tax upon interest derived from federal securities. Where a federal right is concerned, we are not bound by the characterization given to the state tax by the Commissioner, "or relieved by it from the duty of considering the real nature of the tax and its effect upon the federal right asserted." *Society for Savings v. Bowers*, *supra*, at 152, citing *Carpenter v. Shaw*, 380 U.S. 363, 367 (1930).

Taxpayers' income, at issue here, was received in the form of a lump sum distribution from a qualified §401 savings incentive plan established by Banker's

Trust New York Corporation for the benefit of its employees. The Plan was a tax-exempt entity under the provisions of I.R.C. §501(a), not a separate tax entity as asserted by the State. *See* Vermont Department of Taxes, *Memorandum of Law, supra*, at 7. The Plan was one which used a trust to invest the funds contributed by both employers and employees and to distribute the benefits to participants or their beneficiaries. *Prospectus*, at 10-13. This enabled Mr. Keys to save and invest a percentage of his salary tax free until distribution; the income and earnings thereon were not taxed until these amounts were distributed to him, allowing a deferral of both state and federal taxation. *See* I.R.C §§402 and 403.

The amounts contributed by both employer and Mr. Keys were invested in one or more funds at the election of, and in proportions designated by Mr. Keys. *Prospectus*, at 1 and 12. One such fund, Fund (A), was a fund together with the earnings thereon, invested in federal obligations. *Prospectus*, at 10. The $35,000 at issue here was interest on earned contributions attributed to Mr. Keys and invested in Fund (A). The trustee maintained a separate account for Mr. Keys, with separate records for his share in each of the funds selected by him. *Prospectus*, at 4. The investment performance of the five funds over a five year period from 1975-1979, was presented in the prospectus. *Prospectus*, at 13.

In essence, the Plan provided Mr. Keys an investment scheme whereby he could invest tax-free a portion of his otherwise taxable income in a choice of five investment portfolios. The character of the trust assets attributed to Mr. Keys account was irrelevant, prior to distribution, for purposes of federal and state

taxation; the trust per se, as a tax-exempt entity, received no benefit from any tax-exempt or immune interest earned on investments. All incidence of income taxation, both federal and state, commenced upon taxpayers' receipt of the income.

The only substantial difference between Mr. Keys investing personally in federal securities, whose interest would be immune from state income taxation, and the transaction in question, is that the Plan grants Mr. Keys a congressionally approved method whereby both the use of and tax upon the income is deferred. Mr. Keys, not the Plan, decided to invest a portion of his contributions in federal obligations. Mr. Keys, not the plan, was the recipient of the first tax assessment on the interest earned on these federal obligations. An assessment of state income tax on that portion of the distribution was, in reality, a direct tax on interest derived from federal obligations prohibited by 31 U.S.C. §724.

The principles underlying federal taxation of common-law trusts further assist this Court in its duty to consider the true nature of the tax and bolster its conclusion that the assessed tax is illegal. Income from trust property is taxed either to the trust or its beneficiaries as determined by rules found in I.R.C. §§651-668. These rules are premised on the principle that a trust is a conduit through which income can pass untaxed and unchanged in character until it reaches actual beneficiaries. I.R.C. §§652(b), 661(b), 662(b). Simply stated, the income paid out to beneficiaries is taxed just once, and taxed to the beneficiaries, not the trust. I.R.C. §§652, 662. The rules also insure that income will be treated as the same in form to the beneficiary as received by the trust. I.R.C. §§652(b) and 661(b).

The Commissioner concluded that only interest from governmental obligations earned by common-law trusts is immune from taxation because the pass-through of the exempt character of such common-law trust income is authorized by I.R.C. §§652(b) and 661(b). *In re Keys, supra*, at 4. As noted earlier, the absence of a federal revenue statute authorizing the pass-through of income unchanged in character is not relevant for purposes of analyzing a state tax under the provisions of 31 U.S.C. §742(a). No other reason is given to support the Commissioner's conclusion.

Given the expansive scope of constitutional and statutory immunity from state taxation of interest derived from federal obligations, this Court finds no substantial factual basis nor any legal basis for making a distinction between a common-law trust governed by Subchapter J of the Internal Revenue Code and an employee trust, such as the Plan, governed by Subchapter D of the Internal Revenue Code, for purposes of determining the character of income received by taxpayers under the provisions of 31 U.S.C. §742(a). The principles of taxation applicable to common-law trusts should apply equally to the Plan.

Congress determined that the conduit principle underlying common-law trusts should apply to a §401 trust, granting tax-exempt status to such trusts, taxing only the beneficiaries of the trust. *See* I.R.C. §§401 and 402. The statutory framework of a §401 employee trust is analagous to a common-law simple trust. As in a simple trust, a §401 trust is not subject to tax; only the beneficiaries are taxed on income earned by trust assets. *See* I.R.C. §§651 and 652. Under accepted principles of trust-taxation, therefore, interest on federal obligations is immune from state taxation, not in the hands of the original recipient, but in the hands of

the recipient who is first taxed on that income, in this case, taxpayers. In practical operation, the tax in question was in fact a state tax on interest derived from federal obligations.

A construction of the constitutional principle underlying the state tax immunity codified in 31 U.S.C. §742(a) does not depend on the weight of the burden or degree of interference with the constitutional power to borrow money on credit of the United States. *See Macallen Co. v. Commonwealth, supra; New Jersey Realty Title Ins. Co., supra.* The state tax assessment at issue in this case could diminish the investment attractiveness of federal obligations, offered in Fund (A) of the Plan. Although one reason Mr. Keys might have elected to invest in Fund (A) was for investment security, another plausible reason was for state tax benefits. The state tax in issue could interfere with this constitutional power, if only slightly. It was, therefore, unconstitutional. *See New Jersey Realty Title Ins. Co., supra*, at 675 (statute's purpose to prevent taxes which diminish in "slightest degree" investment attractiveness of federal obligations).

For all the foregoing reasons, this Court vacates the Commissioner's determination and orders Vermont State Department of Taxes refund to Plaintiff $203.00 plus interest.

Dated at Woodstock, County of Windsor and State of Vermont, this 21st day of November, 1985.

MATTHEW I. KATZ,
SUPERIOR COURT JUDGE

STATE OF VERMONT
COMMISSIONER OF TAXES

In Re:

Loren D. Keys and Renetta J. Keys
Personal Income Tax for 1981
Appeal No. ATC-83-6
Entered: June 20, 1983

DETERMINATION

I. INTRODUCTION

This appeal considers the personal income tax liability of Loren D. Keys and Renetta J. Keys ("the Taxpayers") for the calendar year 1981.

On May 17, 1983, a formal hearing was held on the appeal. Loren D. Keys appeared for himself and Renetta J. Keys. George Brooks, Attorney for the Vermont Department of Taxes (the "Department"), represented the Department. Norris Hoyt, Deputy Commissioner and General Counsel, served as hearing officer.

The issue in this appeal is whether a "lump-sum distribution" received by Mr. Keys from the Savings Incentive Plan of Bankers Trust New York Corporation ("the Plan") is subject to Vermont income tax to the extent that the distribution constituted income received by the Plan from interest on United States Government obligations.

II. FINDINGS OF FACT

1. Upon his retirement in 1981 Mr. Keys received a "lump-sum distribution" of $141,000 from the Plan.

2. Of that lump-sum distribution, $35,000 represented income from interest on U.S. Government obligations received by the Plan from its investments.

3. The Department and Mr. Keys are in agreement, and it is here found, that if the $35,000 constituted non-taxable U.S. Government interest when paid by the Plan to Mr. Keys, then the Taxpayers are due a tax refund of $203.00, plus interest. If, however, the $35,000 constituted taxable income when paid by the Plan to Mr. Keys, then the Taxpayers owe additional tax of $1,246.00, plus interest.

III. ISSUE PRESENTED

Is the $35,000 paid to Mr. Keys by the Plan nontaxable interest received from U.S. Government obligations in the hands of Mr. Keys, or is it taxable income?

IV. DISCUSSION OF THE ISSUE PRESENTED AND CONCLUSIONS OF LAW

The Taxpayers argue that because the $35,000 paid to Mr. Keys by the Plan is a payment of money which the Plan received as interest on U.S. Government obligations, that Vermont may not tax the Taxpayers on their receipt of this income.

The Department agrees that the $35,000 would not be taxable if Mr. Keys had received it directly from the U.S. Government, as interest on government-obligation investments standing in the name of Mr. Keys. However, the Department argues that this income loses its tax-exempt character when it is paid to another person by the original recipient (here, the Plan) of the interest income from U.S. Government obligations.

The Department offers the analogy of a business which pays its employees' salaries with money derived from investments in U.S. Government obligations. The Department says that while the business was exempt from state taxation on its receipt of the money as income, the employees are not exempt from taxation on their salaries merely because they were paid with funds which at one point were received in a tax-exempt fashion by the business. Mr. Keys agrees that the analogy is correct but believes it does not apply to this case.

The Taxpayers' arguments for non-taxability are the following:

1. The Taxpayers argue that Vermont cannot *constitutionally* tax Mr. Keys' receipt of the money from the Plan.

2. The Taxpayers argue that the Department itself recognizes that the income in question is exempt because:

(a) Line 42 of the Vermont Income Tax Return states that "A bank statement specifying the portion of U.S. Government interest must be attached when such interest is from a trust" and

(b) In 1978, Mr. Raymond R. Centybear, then the Director of Individual Income Tax for the Department, wrote to Mr. Eugene F. Maloney, Associate Corporate Counsel, Trust for Short-Term U.S. Government Securities that: ". . . income from investments . . . is not taxable to residents of the state of Vermont if the trust portfolio consists of those obligations which cannot be taxed by the states under the laws of the United States."

It is hereby held that the income in question on this appeal is properly subject to taxation by the State of Vermont for the following reasons:

1. There is no principle of constitutional law which says that income which originates as interest on U.S. Government obligations is exempt for as long as that specific money can be traced. The Department's example, cited above, of the employer who pays his employees' wages with such interest is a common-sense example of the fact that the Taxpayers' argument in this regard is not correct.

Indeed, the constitutional principle is the opposite: Interest on U.S. Government obligations is exempt from state taxation only in the hands of the original recipient. It requires a specific federal statute to pass through the tax-exempt character of such income to a taxpayer other than the original recipient. See, as examples of such statutes, Sections 652(b), 661(b), and 852 of the Internal Revenue Code. No federal statute authorizes a pass-through of exempt-character on distributions of this kind from an employee trust.

2. The statement quoted by the Taxpayers from line 42 of the Vermont Income Tax Return that "A bank statement specifying the portion of U.S. Government interest must be attached when such interest is from a trust" refers to a "common-law trust" subject to taxation under Subchapter J of the Internal Revenue Code, and not to an Employee Trust of the kind involved here, the taxation of which is regulated by Subchapter D of the Internal Revenue Code.

The pass-through of the exempt-character of such "common-law trust" income is authorized by sections 652(b) and 661(b) of the Internal Revenue Code. The quoted statement from Line 42 of the Vermont income tax return therefore has no relevance or application to this case.

3. The Taxpayers are correct that Mr. Centybear of the Department did send Mr. Maloney the letter stating that: ". . . income from investments . . . is not taxable to residents of the state of Vermont if the trust portfolio consists of those obligations which cannot be taxed by the states under the laws of the United States."

However, notice is hereby taken of the fact that the Department has notified Mr. Maloney that Mr. Centybear's 1978 letter has been revoked as being in error. The letter was in error for the reasons set forth in the immediately preceding paragraphs 1 and 2. It is evident that Mr. Centybear mistakenly applied the "common-law trust" rule under Sections 652(b) and 661(b) of the Internal Revenue Code to a situation, such as that of this case, where it had no application.

For the foregoing reasons, all of the Department's assessments are hereby affirmed.

Dated this 20th day of June at Montpelier, County of Washington, State of Vermont.

STATE OF VERMONT
DEPARTMENT OF TAXES

BY: Norris Hoyt
Deputy Commissioner of Taxes

APPROVED BY:

Elaine K. Hoiska
Commissioner of Taxes

Dated: June 20, 1983

(8)

No. 87-1583

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

VERMONT DEPARTMENT OF TAXES,
Petitioner,

v.

LOREN D. KEYS AND RENETTA J. KEYS,
Respondents.

On Petition for a Writ of Certiorari to the Supreme Court of Vermont

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BRIEF FOR RESPONDENTS IN OPPOSITION

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QUESTION PRESENTED

Does Rev.Stat. § 3701, as amended in 1959, exempt from State income taxation a lump sum payment received by the taxpayer which represents income derived from his investment in a separate retirement fund (qualified under I.R.C. § 401) which invests solely in U.S. Government obligations?

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BRIEF FOR RESPONDENTS IN OPPOSITION [1]

STATEMENT OF THE CASE

We accept petitioner's statement of the case. In addition to the decision of the Supreme Court of Vermont quoted at Pet. 5, we set forth a portion of the Superior Court's opinion which is especially pertinent to the issue before this Court:

> The amounts contributed by both employer and Mr. Keys were invested in one or more funds at the election of, and in proportions designated by Mr. Keys. *Prospectus*, at 1 and 12. One such fund, Fund

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[1] Throughout this brief, "Pet." will refer to the Petition for a Writ of Certiorari.

(A), was a fund together with the earnings thereon, invested in federal obligations. *Prospectus*, at 10. The $35,000 at issue here was interest on earned contributions attributed to Mr. Keys and invested in Fund (A). The trustee maintained a separate account for Mr. Keys, with separate records for his share in each of the funds selected by him. *Prospectus*, at 4. * * *

In essence, the Plan provided Mr. Keys an investment scheme whereby he could invest tax-free a portion of his otherwise taxable income in a choice of five investment portfolios. The character of the trust assets attributed to Mr. Keys account was irrelevant, prior to distribution, for purposes of federal and state taxation; the trust per se, as a tax-exempt entity, received no benefit from any tax-exempt or immune interest earned on investments. All incidence of income taxation, both federal and state, commenced upon taxpayers' receipt of the income.

The only substantial difference between Mr. Keys investing personally in federal securities, whose interest would be immune from state income taxation, and the transaction in question, is that the Plan grants Mr. Keys a congressionally approved method whereby both the use of and tax upon the income is deferred. Mr. Keys, not the Plan, decided to invest a portion of his contributions in federal obligations. Mr. Keys, not the plan, was the recipient of the first tax assessment on the interest earned on these federal obligations. An assessment of state income tax on that portion of the distribution was, in reality, a direct tax on interest derived from federal obligations prohibited by [Rev. Stat. § 3701]. [Pet. 18a-19a.]

REASONS FOR DENYING REVIEW

1. The Supreme Court of Vermont has ruled here and in "a companion case" (Pet. 1),[2] that Rev. Stat. § 3701,

[2] *In re Sawyer Estate*, —— Vt. ——, —— A.2d —— (Dec. 11, 1987), reprinted at Pet. 3a-8a.

31 U.S.C. § 3124(a), exempts from State income taxation interest on federal obligations that is received by the taxpayer as a lump sum payment from an individually directed retirement fund which invests solely in federal obligations (or as a dividend from a registered investment company which so invests). Petitioner acknowledges that these decisions are in accord with the decisions of courts in six states. Pet. 8-9, citing cases. There are no contrary judicial decisions.

On March 21, 1988, this Court denied certiorari in one of the cited cases, *Illinois Department of Revenue* v. *Andras*, 56 L.W. 3647, denying review of *Andras* v. *Illinois Department of Revenue*, 154 Ill. App. 3d 37, 506 N.E. 2d 439 (1987). The question presented by the petition in this case is identical in every material respect to that presented in *Andras*, and petitioner does not contend otherwise.[3] Nor does petitioner present anything of substance which was not before this Court when it denied review in *Andras*. Indeed, the petition in that case was supported by a brief *amici curiae* prepared by the Attorney General of Vermont and his present co-counsel.[4] Accordingly, our discussion herein will be brief.

2. The decision below (see Pet. 1a, 5a-6a), as well as the others cited at Pet. 9, followed the construction of § 3701 in *American Bank & Trust Co.* v. *Dallas County*, 463 U.S. 855 (1983) ("*American Bank*"):

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[3] Here, respondent taxpayers received interest on federal obligations in the form of a lump sum payment from a retirement fund where they had designated the investments to be made. In *Andras* and *In re Sawyer Estate* (as well as the other cases cited at Pet. 9), the taxpayers received interest on federal obligations as dividends from a registered investment company (*i.e.*, mutual fund). In deciding the present case on the authority of *Sawyer Estate*, the court below treated these issues as indistinguishable, and the petition follows the same approach. We shall do likewise herein.

[4] Brief for the States of California, *et al.*, as *amici curiae*, No. 87-1142.

> The exemption for federal obligations provided by § 3701, as amended in 1959, is sweeping: with specific exceptions, it "extends to *every form* of taxation that would require that either the obligations or the interest thereon, or both, *be considered, directly or indirectly, in the computation* of the tax." [463 U.S. at 862; see Pet. 5a-6a, this Court's emphasis.]

Petitioner concedes, on the authority of *American Bank*:

> The statute would prohibit, by way of example, a tax on pension income that was computed by determining the income received by the pension fund, including its income from federal obligations, and taxing each pensioner on a proportionate share of the [pension] fund's income. [Pet. 12.] [5]

Yet, petitioner argues that

> Vermont imposes a broad based tax on income earned or received by a corporation, individual, estate or trust. This income includes pensions. The tax is measured solely by the amount of income received by the taxpayer. The tax in no way considers the assets of the payor or the source of any income earned by the payor. [*Id.*]

That is a distinction without a meaningful difference. An identical argument was made to and rejected by a California court in *Brown* v. *Franchise Tax Board*, 242 Cal. Rptr. 810 (Cal. Ct. App. 1987). That court's reasoning is so apposite and lucid that it merits extensive quotation:

> The Board asserts that the tax before us is not "measured directly or indirectly" by income from federal obligations, but concerns only "dividends" paid by Companies [mutual funds] to their investors. The Board contends that this distinction flows from the general principle that "a corporation is a nonconductor that cuts off connection between dividends

[5] Petitioner inadvertently wrote "mutual fund's".

to its stockholders and the corporate funds from which the dividends are paid." (*Miller* v. *Milwaukee* (1927), 272 U.S. 713, 714, 47 S.Ct. 280, 280, 71 L.Ed. 487.) However, this point is reminiscent of the "formal but economically meaningless" distinctions which were previously held to permit taxation of bank shareholders even if the underlying assets were federal securities—distinctions which became untenable with the 1959 amendments to the federal statute. (See *American Bank, supra*, 463 U.S. at pp. 858, 871, fn. 14, 1403 S.Ct. at pp. 3372, 3379, fn. 14.)

Moreover, as applied here, the "nonconductor" principle is less than "economically meaningless"; as a functional matter, it is wrong. The plaintiff Companies are not ordinary corporations, but registered investment companies whose business is to provide a conduit for investment in federal securities by persons who might otherwise be unable or unwilling to enter that market. The ability to pool investments in such funds stimulates the market for such securities by lowering the minimum investment necessary to participate in a given type of security, spreading the risks and rewards associated with (for example) fluctuating interest rates, and providing greater convenience and liquidity than would often be realized with individually purchased securities. Congress expressly recognized the "conductor" role of such companies when it declared, in the Investment Company Act of 1940, that they are "*media* for the investment in the national economy of a substantial part of the national savings," which "may have a vital effect upon the *flow of such savings* into the capital markets." (15 U.S.C.A. § 80a-1(a)(4) * * *.)

The constricting effect of this tax on a congressionally recognized conduit for investment capital must be weighed, together with the legislative goal of preserving the market value and investment attractiveness of federal securities, in subjecting this tax to the statutory test, i.e., whether the proceeds of federal securities are *directly or indirectly* taken

> into account in computing the tax. In this context, the [taxing authority's] claim that it is blind to the origin of the distributions paid to the plaintiff class, even if accepted, is without economic significance. Unless Congress directs otherwise, the distributions [such] companies pay to their investors must be considered as so closely identified with their source that the computation of the tax involves indirect consideration of federal obligations. [242 Cal. Rptr. at 812-813. (Court's emphasis, footnote omitted).]

The foregoing analysis not only disposes of petitioner's argument that the interest on federal obligations is not "considered directly or indirectly, in the computation of the tax," but also demonstrates why recognition of the exemption is essential to effectuate the purpose of § 3701. Petitioner does not contend otherwise with respect to either mutual funds or, as here, individually directed pension plans. Thi sis decisive, because even before the 1959 amendment to § 3701, it had been settled that the statute's purpose is "to prevent taxes which diminish in the slightest degree the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit." *Smith* v. *Davis*, 323 U.S. 111, 117 (1944); *N. J. Ins. Co.* v. *Div. of Tax Appeals*, 338 U.S. 665, 675 (1950).[6]

3. In asserting that the present case is important, petitioner attributes to the decisions of the court below in this case and in *Sawyer* ramifications far beyond their actual scope. It asserts that under those decisions, the states would be prohibited from taxing "dividends paid by an ordinary business corporation or interest paid on bank deposits, so long as the payee could satisfy its

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[6] Insofar as petitioner seeks to limit the scope of the 1959 amendment by pointing to what the legislative history shows was the catalyst of that amendment (Pet. 12-14), it repeats an argument unsuccessfully made by petitioners in *Andras*, and, even more to the point, by respondent taxing authorities in *American Bank*. See 463 U.S. at 865-867.

burden of tracing the payment to the payor's investment in federal obligations." Pet. 10. But this argument disregards the fundamental differences between the rights of the shareholder of a corporation, and those of a shareholder in a mutual fund (or investor in an individual retirement account). See *Brown*, *supra*.

Petitioner goes even further, arguing that it "logically follows [from the decision below] that Vermont could also be prohibited from taxing salaries paid to employees, rent paid to a landlord, . . . if it could be shown that this income was paid with money that the payor received as interest from the federal obligations." Pet. 10.[7] Petitioner's "logic" is fallacious; the tax laws long ago solved the conundrum which petitioner poses. Notwithstanding the assignment, if the interest income were taxable, it would be taxable to the owner of the obligations (the assignor) and not to the assignee. *Helvering* v. *Horst*, 311 U.S. 112 (1940); cf. *Lucas* v. *Earl*, 281 U.S. 111 (1930). Therefore, it is the assignor alone who benefits when the interest is exempt from taxation. Neither the tax nor the exemption may be shifted. In Justice Holmes' words, the law disregards "the arrangement by which the fruits are attributed to a different tree from that on which they grew." *Id.* at 115. But there is no impermissible shifting when an investor is exempted from taxation on the interest on federal obligations which he receives as a lump sum payment from his own retirement account.

4. At the close, petitioner proffers an argument which was not made in *Andras*—it seeks to analogize its position to the decisions which rejected the view that a tax on the income of a government employee is a tax on his government employer and must therefore be immune. *E.g.*, *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. 466

[7] Similar hypothetical "horribles" were advanced at pp. 11-12 of the petition for certiorari in *Andras*.